

Tuesday, February 26, 2008

California Focus: Taxman has eye on your downloads

Legislature considers taxing digital goods, like downloads

By MICHELLE STEEL

Steel serves on the Board of Equalization, a state taxing agency, representing the 3rd District, which includes Orange and Los Angeles counties.

Leave it to Assembly Democrats to connect Apple's digital entertainment and information revolution and our \$16 billion state budget deficit. Last week, Assemblyman Charles Calderon, D-Montebello, introduced legislation to create California's very own "iTax," and this i-dea is one innovation that Californians definitely can afford to pass up.

Assembly Bill 1956 would require the Board of Equalization to impose sales taxes on "digital products" like music, movie and software downloads, which many if not most people may know through Apple's iPod music and video player and iTunes online music and video store. This new "iTax" would stifle innovation, hurt our state's robust e-commerce economy, and make a negligible dent in our state's budget deficit. Most importantly, AB1956 is an illegal tax increase.

To understand this looming threat, take a moment to understand California's basic sales and use tax law. California's sales and use taxes can only be levied on the sale of tangible personal goods. Apple's innovations have revolutionized the way that consumers access entertainment. Increasingly, consumers are choosing to forgo a tangible CD or DVD in favor of a downloadable MP3 music file or video. Because no tangible goods are physically transferred, California lacks the legal authority, for now, to apply sales taxes on these transactions.

Behold the iTax. The Democrats who control both the state Assembly and Senate know that an unpopular new tax increase is unlikely to receive the constitutionally mandated, two-thirds vote for approval in the Legislature. Like sneaky, malicious spyware, AB1956 avoids the two-thirds vote requirement by requiring the Board of Equalization to merely redefine digital downloads as tangible personal property. Voila, an intangible product becomes tangible overnight and subject to tax by regulatory fiat.

Minus the blatant illegality of this bill, an iTax in general terms is bad public policy. Tax policy is routinely used as a mechanism for encouraging behavior. Prior to online music stores like iTunes, companies and performers lost billions of dollars every year to illegal file downloads and file-sharing. The music industry continues to struggle with piracy problems.

State government should encourage legal digital downloads because they are better for everyone. Consumers instantly receive the product. Businesses save money on packaging. The environment benefits from fewer trips in your car and less waste sent to landfills. Digital downloads are safer, too. According to the latest issue of Wired Magazine, almost 6,500 people were admitted to emergency rooms in 2004 with injuries sustained while opening plastic media packaging.

When it comes to generating revenue, an iTax would be as effective as your e-mail program's spam filter. Online media stores could easily create a separate entity out-of-state; thereby, avoiding sales taxes altogether. Under such a situation, California taxpayers would be obligated to report those purchases individually and pay the "honor system enforced" use tax, which has a 99.8 percent noncompliance rate.

While California loses some sales tax revenue from online commerce, the economic benefits of e-commerce far outweigh any lost taxes. More so than any other state, online commerce has been an economic boon for California. Online commerce brings high-paying jobs, major economic benefits, and significant tax revenue to the Golden State. State government has received increased capital gains, property, income and business taxes from e-businesses.

Last year, capital gains from the stock sales of just 16 Google employees generated \$380 million in tax revenue for California. Compare that to less than \$1.1 billion in lost California tax revenue from all of e-commerce and mail-order businesses. Just 16 Google employees' capital-gains taxes offset close to 40 percent of the lost use-tax revenue from all of e-commerce.

AB1956 is a bad idea; it subverts the state constitution and creates a new tax. California's \$16 billion budget deficit cannot be solved by taxing downloads. Apple has changed the way that consumers access media entertainment. That's the kind of innovation that deserves encouraging, not innovative taxing strategies.